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June 16, 2008

AGENDA ITEM 4

TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE

I. SUBJECT: Inflation-Linked Asset Class Policy – Adoption of Infrastructure Program Component (SECOND READING)

II. PROGRAM: Inflation-Linked Asset Class Policy

III. RECOMMENDATION: Recommend to the Investment Committee adoption of the Infrastructure Program Component of the Inflation-Linked Asset Class

IV. ANALYSIS:

BACKGROUND

The first reading of the Infrastructure Policy was presented to the Policy Subcommittee on April 21, 2008. The Subcommittee requested several changes to the document. Subsequent to the meeting, staff circulated a revised draft to interested parties and received additional comment. Staff then made additional changes to the proposed policy.

A major change is the inclusion of the portfolio strategy and construction in the body of the policy rather than the Annual Plan. Other language changes relate to the Responsible Contractor Policy and Public Sector Jobs. This revision incorporates those changes as well as additional elements that staff included for completeness (Attachment 1). Changes from the first reading are shown in redline format.

REVISIONS
The substantive changes to the policy are highlighted below:

Section VI - Investment Approaches and Parameters
B. Infrastructure Program Strategy

The program strategy includes four segments: Portfolio Allocation and Leverage; Program Risk Matrix; Regional Allocation; and Concentration Limits. These segments of Program Strategy were developed by staff based on research, prior experience, consultations with external fund managers and review of offering materials of several infrastructure funds.

Allocation Ranges
In a start-up program of this nature in private investments, it is difficult to envision exactly what the construction and characteristics of the portfolio will be like in the future when fully invested. Although the infrastructure space is very large with funding needs estimated to be in the trillions of dollars, it is an emerging asset class for institutional investing and hence lacks a well-defined proxy or reference for portfolio construction. In private investments, access to attractive opportunities is the key determinant of future returns; hence this policy aims to pursue an “opportunistic” strategy, i.e. the program will target the most attractive opportunities available at the time rather than seek to fill particular segments. Hence the target allocations for the various strategies need to have broad ranges. On the whole, core and value add strategies, which represent the low and medium risk segments inclusive of listed securities if any will have the dominant exposure in the range of 80% to 100%. At the minimum the low to medium risk segments will account for 80% of the program if the maximum allocation to the higher risk opportunistic (20%) is obtained.

Regional allocations also have a wide band to facilitate the “opportunistic” investment strategy. It is expected that U.S. exposure will be dominant once the program is fully invested.

Leverage
It is expected that on average, leverage for the core, value add and opportunistic categories will be less than or equal to 75%, 65%, and 60% respectively. A higher leverage limit has been set for an individual investment within each category to provide flexibility.

The benefit of financial leverage arises from the possibility that funds borrowed at a fixed interest rate can be used for investment in opportunities earning a higher rate of return than the cost of debt. This difference is a gain for equity holders or owners. The reference here is to the after tax cost of debt or interest rate after taxes, which is lower than the interest rate charged by the lender, since interest is a tax-deductible expense. As leverage is increased return on equity increases sharply in a non-linear fashion provided the rate of return on the investment is greater than the interest rate. Should the rate of return on the investment fall below the interest rate, the opposite effect will occur and return on equity can decline sharply. The rate of increase or decrease in return on equity is higher at higher levels of leverage. This imposes leverage risk for the equity holder.

From a lender's point of view, higher levels of leverage increase the risk of default if earnings decline and are not adequate to meet debt payments. The cushion that is available to pay interest and principal payments on the debt is measured by the debt service coverage ratio (DSC). Lenders will typically impose limits on debt levels to be used by the borrower and also require that DSC be maintained at a level higher than 1.0.

Businesses with stable operations and cash flows will typically have a higher level of debt than businesses with less stable cash flows. Since infrastructure investments are typically characterized by long-term concessions or off-take agreements with pricing adjustments linked to inflation, they can sustain acceptable levels of DSC at higher levels of leverage. Hence a higher level of leverage may be an acceptable risk for this type of investment while it may be considered too high for investments that do not have such operational characteristics.

Currently, CalPERS has policy limits on leverage of 50% for core real estate and forestland and 75% for non-core real estate. The leverage limits for infrastructure proposed in the policy are reasonable compared with the existing policy limits in real estate and forestland and more so in comparison to the favorable cash flow characteristics of infrastructure assets. Further restrictions on leverage will likely impinge on the flexibility required to gain access to attractive partnership and co-investment opportunities.

Concentration Limits

In order to ensure sufficient diversification, concentration limits have been specified for a single investment and aggregate commitments to single general partner, fund or separate account. The program will primarily consist of equity investments. Debt investments are limited to 30%. The expected return would be higher for equity investments than debt investments as a risk premium.

Section VI - Investment Approaches and Parameters
D. Responsible Contractor Program, Preference and Domestic Public Sector Jobs

1. Responsible contractor policy and preference
   e. Section on enforcement was added.

2. Domestic Public Sector Jobs
   a. Section on California Public Sector Jobs was strengthened.
   b. The standard for adverse impact on public employees was changed to "de minimis". The definition of "de minimis" is included in the glossary.
   c. Section on enforcement was added.

3. Other considerations
   This section was deleted as the language on enforcement is now specified separately under 1(e) and 2(c) above and the reference to impact on the jobs of CalPERS plan participants is addressed more broadly as California Public Sector Jobs in Section 2(a) above.

Section VI. – Investment Approaches and Parameters
F. Management of Direct Investments

3. Subsection was added to require that necessary pre-conditions must be met before direct investments can be made.

Section VII. Permissible Investments
B. Structures and Investment Vehicles.
   7, 8. Subsections were added to specify the types of listed securities or related derivatives.

H. Use of Leverage
   Language was added to clarify the basis for evaluating leverage risk.

Opinion letters from PCA and Wilshire Associates are attached (Attachments 2 & 3).

PROCESS

As in the case of the first reading of this policy, the second reading was also sent to the various constituent groups (SEIU, LIUNA, AFSCME, PECG, California School Employees Union, Unite Here) for their review and comments. Comments received are summarized in Attachment 4. As noted above, staff has reviewed and made changes, as appropriate, based on these comments.

V. STRATEGIC PLAN:

This item is consistent with Strategic Plan Goal VIII, manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first to pay benefits and second, to minimize and stabilize contributions. This item is also consistent with Goal IX, achieve long-term, sustainable, risk-adjusted returns.

VI. RESULTS/COSTS:

As described in the September 2007 Investment Committee open session item 4c, the projected ILAC staffing and consulting costs are $1.8 million for 2007-08 and $1.7 million for 2008-09. These projections include the costs of hiring the Staff needed to manage the infrastructure and forestland programs and also assist existing Staff manage the commodities and inflation-linked bond programs.

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